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No. 93

In the Supreme Court of the United States

OCTOBER TERM, 1944

W. G. CHOATE, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE TENTH CIRCUIT

BRIEF FOR THE RESPONDENT

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OPINIONS BELOW

The opinion of the Tax Court (R. 13–23) is not officially reported. The opinion of the Circuit Court of Appeals (R. 43–47) is reported at 141 F. 2d 641.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered March 13, 1944 (R. 47). Motion for rehearing was denied April 8, 1944. (R. 53.) Petition for a writ of certiorari was filed on May 23, 1944 (R. 55), and was granted on October 9, 1944 (R. 54), limited to the second question pre-

sented by the petition for the writ. The jurisdiction of this Court rests upon Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTION PRESENTED

Taxpayer and his partner during the tax year transferred the working interest in an oil and gas lease including the fixed equipment, retaining an overriding royalty and receiving a cash bonus. In determining net income for the year of the transaction may the partners, who have thus retained a share in production, treat the bonus as a tax-free return of capital to the extent of their undepreciated equipment cost, or must the entire bonus be considered ordinary income subject to depletion?

STATUTES AND REGULATIONS INVOLVED

The pertinent statutes and regulations are set forth in the Appendix, *infra*, pp. 30–33.

STATEMENT

The material facts as found by the Tax Court (R. 14–21) may be summarized as follows:

In 1924 a Mrs. Baker executed for a cash consideration and a retained one-eighth royalty an oil and gas lease on land she owned in fee in Upton County, Texas (R. 14). On December 18, 1936, by mesne assignments the lease (insofar as it covered and affected oil and gas to the depth of 2,750 feet and subject to an overriding royalty

of one-sixteenth of the gross production) was acquired by a copartnership known as "Choate & Hogan," of which the taxpayer was a member (R. 15). The partnership drilled six producing wells on the leased land and operated the property until August, 1938 (R. 16).

On August 11, 1938, the partnership contracted in writing (R. 16–17, 36–40) to assign its interest in the leasehold,[1] save and except an overriding one-eighth royalty, for a cash consideration of $110,000. By an instrument of assignment (R. 9–10) executed on August 22, 1938, pursuant to the contract the partnership did "bargain, sell, assign and convey" all its right, title and interest in the Baker lease (i. e., to the depth of 2,750 feet)—

> together with all wells and the equipment thereof, including pumps, casing, piping, tanks, lease house, and all other personal property on or used in connection with said premises, including oil in storage to Sylva Oil Company, * * * save and except that assignors herein expressly reserve to themselves * * * and do not assign or convey * * * 1/8 of 8/8ths of all oil and gas and casinghead gas which may be produced and saved * * * from the aforesaid land * * *.[2]

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[1] The partnership had a thirteen-sixteenths interest in the total production at the time.

[2] One-half of the partners' overriding royalty was reserved in the name of Fred T. Hogan and the other one-half in the

By a letter from Sylva Oil Company to one of the partners, executed on the date of the assignment, it was specified that Sylva was not purchasing unaffixed or movable equipment, but was "only acquiring the personal property actually used and attached to such producing wells on the lease," together with the house on the lease (R. 17.)

At the date of the transaction with Sylva Oil Company the undepleted cost to the partnership of its thirteen-sixteenths interest in the Baker lease was $23,583.78 and the undepreciated cost of the fixed equipment was $23,090.60 (R. 18).

In its income tax return for 1938 the partnership treated the transaction with Sylva as a sale (R. 18–19). It allocated $11,545.30 of the cash payment (exactly half its remaining cost) to the fixed equipment, as consideration received for the latter, and consequently claimed a loss of $11,545.30 on the equipment. The partnership then allocated the balance of the cash, or $98,454.70, to the leasehold and, after deducting its cost, less depletion theretofore sustained, plus commissions,[3] reported a net capital gain of $71,870.92 from this phase of the transaction. The partners reported their respective distributive shares of partnership net income accordingly (R. 19).

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name of taxpayer's brother, L. H. Choate, acting for himself and the taxpayer (R. 16–17). Thus taxpayer remained entitled to one-thirty-second of the total production.

[3] The commission paid was $3,000 (R. 20).

Upon audit of the partnership return the Commissioner held the transaction a sub-lease and that the $110,000 bonus less commission was taxable as ordinary income, subject to the deduction of percentage depletion[4] in the amount of $30,250[5] (R. 19–20).

The Tax Court held that the equipment was sold absolutely and that the taxpayer was entitled to an allowance against the bonus for the unrecovered cost of the equipment in computing his taxable income for the year 1938, but otherwise upheld the Commissioner's determination (R. 21–23). The Circuit Court of Appeals reversed, in so far as the Tax Court had reversed the Commissioner, and thereby sustained the Commissioner's determination *in toto* (R. 43–47)

In the companion case of the taxpayer's partner, *Hogan* v. *Commissioner,* 141 F. 2d 92, the Circuit Court of Appeals for the Fifth Circuit on February 25, 1944, affirmed the decision of the Tax Court in all respects, and thus created a conflict of decisions with respect to the proper treatment of the equipment costs.

SUMMARY OF ARGUMENT

The rule for which taxpayer contends is based upon the assumption that the parties intended a

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[4] Depletion of 27½ per cent on $110,000 is $30,250.

[5] Thus the Commissioner determined that the partnership realized ordinary income in the amount of $76,750 in 1938 from the transaction with the Sylva Oil Company (R. 20).

separate cash sale of the equipment. This assumption is contradicted by the record, it appearing that no part of the bonus was in fact paid for the equipment. While it is recognized that the case may be decided upon this narrow ground, the Government is contending for a broader rule. This leasehold with its six fully equipped wells constituted an operating property. In transferring that property subject to the reserved one-eighth interest in its gross output, the partnership retained not only an economic interest in the oil in place measured by a share of production, but also a right, recognized by the courts, to have the production equipment continued in use as an operating plant as long as the wells were capable of producing oil. A taxpayer retaining such an interest may not avoid the tax consequences of the transaction by purporting to make a separate sale of the equipment required for production. The case is similar to that of an owner or lessee of improved real estate who leases or subleases the land and at the same time purports to sell the building for cash. Such a "sale" will not be recognized for tax purposes, the cash payment being taxable as rent.

The oil in the ground has been characterized by this Court as a "reservoir of capital investment of the parties." Immediately prior to the transaction of August 22, 1938, the partnership's capital investment in this "reservoir" was composed of

its undepleted leasehold cost and the undepreciated cost of the equipment installed in the wells. In its changed relationship to the property resulting from the transaction this capital investment was converted into a royalty interest or right to share in the oil or its proceeds, payable partly in advance by way of the bonus, and the capital cost of this interest was recoverable only through depletion. If the partnership had not accepted a bonus but instead had reserved a larger royalty, a common arrangement in the oil industry, it is incontrovertible that the partners' aggregate investment in the property, including the equipment cost, would have remained as the cost basis of the royalty interest and would be recoverable only through the depletion allowance. The payment of the bonus or advance royalty did not alter the character of the transaction any more than an unusually large rental payment in the first year alters the character of an ordinary lease.

The taxpayer's argument that the cost of physical equipment may not under the law be recovered through depletion fails to take into account the changed relationship of the partnership to the property resulting from the transaction which altered the nature of its interest. After the transfer its investment was no longer in leasehold and equipment as such, but was an economic interest in an oil producing enterprise, an interest meas-

ured by the production of oil, a depletable interest. The cost of that interest was what the partnership had put into it, its contribution to the reservoir of capital investment, measured by the remaining cost of its original investment in the leasehold and equipment.

ARGUMENT

THE TAXPAYER AND HIS ASSOCIATES ARE NOT ENTITLED TO DEDUCT THE UNRECOVERED COST OF THE EQUIPMENT FROM THE BONUS RECEIVED FOR THE SUBLEASE

Immediately prior to August 22, 1938, the partnership of which taxpayer was a member was the holder of a thirteen-sixteenths operating or working interest in an oil producing property, acquired by assignment. The partnership had drilled six wells on the property, which were producing oil, and had installed in these wells casings, pumps, piping and possibly other equipment. The partnership's undepleted leasehold cost was $23,583.78. The undepreciated cost of the equipment was $23,090.60. It does not appear how this latter cost was distributed among the several items of equipment, but it is fair to assume that a very substantial part of the cost was attributable to the casings, which could not be removed without destroying the wells.[6] The rest of the equipment

[6] Casings are ordinarily cemented into place; the lower part of the casing cannot be removed at all and the removal of the upper part above the cement backing will destroy the well.

was attached to these producing wells and was necessary for their continued operation.

Pursuant to a contract dated August 11, 1938, the partnership on August 22, 1938, executed an instrument (R. 8–12) transferring the working interest to the Sylva Oil Company. This transaction was of a type common in the oil industry. The partnership reserved a one-eighth royalty interest, "1/8 of 8/8ths of all oil and gas and casinghead gas which may be produced and saved by Sylva Oil Company" (R. 10). The company paid a cash bonus of $110,000. It agreed to continue the development of the property (R. 10). By the instrument of transfer, which is titled "Assignment of Oil and Gas Lease", the partnership purported to transfer, subject to the reserved royalty, all its leasehold rights (R. 10)—

> together with all wells and the equipment thereof, including pumps, casing, piping, tanks, lease house, and all other personal property on or used in connection with said premises * * *.

This language respecting the equipment was qualified by a letter of even date with the assignment in which the company stated (R. 17) its understanding that it was "only acquiring the personal property actually used and attached to such producing wells on the lease," besides the house on the lease.[7]

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[7] The August 22, 1938, letter is not reprinted in the record as it comes to this Court. The findings of the Tax Court (R. 17) quote the important parts of the letter.

The issue now before this Court concerns only the equipment.[*] The taxpayer contends that as to the equipment this was a closed transaction, an outright sale for cash, and that to the extent of the undepreciated cost of the equipment the cash bonus must as a matter of law be considered as paid for the equipment and so recovered tax free as a return of capital. This contention is based upon the assumption that the parties intended a separate cash sale of the equipment. This assumption is contradicted by the record. The instrument of assignment which refers to the equipment *makes no reference to the bonus.* The bonus was paid pursuant to a preliminary contract dated August 11, 1938 (R. 36–40), under which the partnership "proposes to execute and deliver an Assignment of such Oil and Gas Lease, hereinabove described" (R. 37) and in which it is provided that the "consideration to be paid Seller by Buyer is the sum of One Hundred Ten Thousand Dollars ($110,000.00) in cash, upon the de-

[*] So far as the leasehold is concerned, the transaction was not a sale, and the proceeds of the royalty and bonus paid for the leasehold were ordinary income subject to depletion and not a return of capital. The court below and the Circuit Court of Appeals for the Fifth Circuit, which decided the companion case of *Hogan* v. *Commissioner*, 141 F. 2d 92, have so held, affirming the Tax Court, in accordance with well-settled principles announced by this Court (*Burnet* v. *Harmel*, 287 U. S. 103; *Murphy Oil Co.* v. *Burnet*, 287 U. S. 299; *Palmer* v. *Bender*, 287 U. S. 551; *Herring* v. *Commissioner*, 293 U. S. 322) and this Court on October 9, 1944, denied certiorari with respect to this issue.

livery of proper assignment of Oil and Gas Lease" (R. 39). This contract *makes no reference to the equipment*, the bonus being described as the consideration to be paid for the leasehold.

The taxpayer is accordingly asking that there be invoked here a wholly artificial rule of law, a rule which would compel the Commissioner for tax purposes to treat any cash bonus paid in connection with the transfer of a developed oil property as *ipso facto* paid upon a sale of the equipment, to the extent of its undepreciated cost, and so to permit the latter to be recovered tax free, even in contradiction of the actual contract which the parties have made. Although the Tax Court here adopted this view, as did the Circuit Court of Appeals for the Fifth Circuit in deciding the companion case of *Hogan* v. *Commissioner*, 141 F. 2d 92, we submit that this contention was correctly rejected by the court below in the instant case.

While we recognize that this case may be decided upon the narrow ground that according to the record no part of the bonus was as a matter of fact paid for the equipment, the Government is contending for a broader rule. This leasehold, consisting of an interest in oil bearing lands, together with its six fully equipped producing wells, constituted an operating property. In transferring that property subject to the reserved one-eighth interest in its gross output, the partnership retained not only an economic interest in the oil

in place measured by a share of production, but also a right, implicit though not expressed in the contract, to have the production equipment continued in use as an operating plant as long as the wells were capable of producing oil in commercial quantities. A taxpayer retaining such an interest should not at the same time be permitted to avoid the tax consequences of the transaction by purporting to make a separate sale of the equipment.[9]

The case does not differ in substance from that of the owner or lessee of improved real estate who leases or subleases the land and at the same time purports to "sell" the building. Such a "sale" will not be recognized for tax purposes, and the stated consideration for the building is taxable as rent and is not a return of capital, notwithstanding that such consideration may be paid in a lump sum at the time the lease is executed and pursuant to a separate contract of sale. *Gates* v. *Helvering*, 69 F. 2d 277 (C. C. A. 8th); *Crile* v. *Commissioner*, 55 F. 2d 804 (C. C. A. 6th), certiorari denied, 287 U. S. 600.

This Court has referred to the oil in the ground as "a reservoir of capital investment of the several parties." *Palmer* v. *Bender*, 287 U. S. 551, 558.

[9] A different case would of course be presented if the equipment were not attached to or closely associated with the wells, but consisted of movables not necessary to the contemplated continued use of the property, or if the wells were exhausted and the equipment were sold at its salvage value.

Immediately prior to the transaction of August 22, 1938, the partnership's capital investment in this "reservoir" was $46,674.38, the total of its undepleted leasehold cost and the undepreciated cost of the equipment installed in the wells. Both items of cost, the cost of the license to produce the oil together with any capitalized exploration and drilling costs, and the cost of the fixed equipment required for its production, represented an investment in the oil in place, just as the cost of a building represents an investment in the real property upon which it is erected. Indeed, the relationship is even closer in the case of the operating oil property. The value of the fixed equipment is peculiarly dependent upon the petroleum deposit. Exhaustion of that deposit reduces a substantial part of the equipment to a salvage value. And removal of equipment necessary for the continued extraction of oil impairs the interest in the oil deposit.

Had the partnership kept the property, its investment would have been returned to it tax free through depletion and depreciation allowances over the productive life of the property. *United States* v. *Dakota-Montana Oil Co.*, 288 U. S. 459. Alternatively, the investment might have been sold outright and the entire cost basis recovered tax free out of the proceeds of the sale. The partnership did not elect to proceed in either of these ways. It chose rather to retain its investment

in the property in the form of a royalty (payable partly in advance by way of the bonus)[10] while transferring to others the burdens and the benefits of the working interest. In the partnership's changed relationship to the property its capital investment in leasehold and equipment was converted into a royalty interest, a mere right to share in the oil or its proceeds, and the capital cost of this interest should be recoverable only through the depletion allowance.

The contention of the Government may be illustrated by supposing that no bonus had been paid[11] or that the partnership had retained, not a one-eighth royalty plus bonus, but a larger royalty, say one-fourth, and no bonus. Transactions of this type, where only a royalty is reserved, are also common in the oil industry. The tax consequences of such a transaction are clear. The investment in the property represented by leasehold and equipment costs would remain as the cost basis of the royalty interest and would be recoverable only through the depletion allowance, the partnership's resulting capital asset in the new relationship being merely a right to share in

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[10] *Murphy Oil Co.* v. *Burnet*, 287 U. S. 299.

[11] On the basis of the record this need not be considered an hypothetical case, since the bonus was paid under the contract of August 11, 1938, as the consideration for the leasehold, and so far as the equipment is concerned it is as though no bonus had been paid.

the oil as produced or its proceeds.[12] If the partnership had been an outsider not theretofore interested in the property and had contributed to the enterprise depreciable equipment to be installed in the wells, in return for a royalty, an oil-payment right or other form of economic interest, its cost represented in the equipment would

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[12] The several possible alternatives to this treatment require only to be stated to be rejected:

1. That the equipment has been disposed of without consideration and at a total loss. Clearly the transaction as a whole did not result in a loss and the magnitude of the royalty interest may be attributed in no small part to the fact that this was a transfer of developed property.

2. That the equipment has been sold on an installment sale basis. But no price, installment or otherwise, has been fixed; the royalty payments are measured by production and without reference to the equipment.

3. That the partnership is entitled to continue to take depreciation in respect of the equipment. This would involve the retention of a share in the working interest and a correlative responsibility for the upkeep of the equipment. See Treasury Regulations 101, Article 23 (m)-18 (Appendix, *infra*), in which the depreciation allowance is restricted to taxpayers "operating oil or gas properties"—the assignee in the instant case. Compare cases holding that a lessor is not entitled to depreciation where the lessee has assumed full responsibility with respect to the maintenance of the property. *Georgia Ry. & Electric Co. v. Commissioner*, 74 F. 2d 897 (C. C. A. 5th), certiorari denied, 296 U. S. 601; *Commissioner v. Terre Haute Elec. Co.*, 67 F. 2d 697 (C. C. A. 7th), certiorari denied, 292 U. S. 624; *Atlantic Coast Line R. Co. v. Commissioner*, 81 F. 2d 309 (C. C. A. 4th), certiorari denied, 298 U. S. 656.

None of these alternatives, it is submitted, is in keeping with realities of the transaction.

be treated as the acquisition price of an investment in the oil in place, recoverable solely through the depletion allowance. *Commissioner* v. *Rowan Drilling Co.*, 130 F. 2d 62, 64–65 (C. C. A. 5th); *Lee* v. *Commissioner*, 126 F. 2d 825 (C. C. A. 5th); *Hardesty* v. *Commissioner*, 127 F. 2d 843 (C. C. A. 5th); *Hunt* v. *Commissioner*, 135 F. 2d 697 (C. C. A. 5th); *Kiesau Petroleum Corp.* v. *Commissioner*, 42 B. T. A. 69. See also *Commissioner* v. *I. A. O'Shaughnessy, Inc.*, 124 F. 2d 33 (C. C. A. 10th). These cases involved drilling contractors or equipment dealers who had drilled or equipped wells for others in return for oil-payment rights. It was held that the cost of the equipment or the expense incurred by the driller must be capitalized as the cost of the oil-payment right, to be recovered through the depletion allowance. The driller or party furnishing equipment is considered as having made an investment in the oil in place and it is immaterial that that investment is represented by his cost of depreciable property or by other items of cost which would ordinarily be deductible as business expense. In the case at bar the partnership has likewise made a contribution to the enterprise in the form of depreciable equipment and, like the driller or equipment dealer, has emerged with a royalty interest the cost of which, although traceable in part to the equipment, is recoverable only through the allowance for depletion.

The payment of the bonus, even if it had been treated by the parties as the consideration for the equipment, would not change the essential nature of the contract. So far as the leasehold is concerned it is settled law that the "payment of an initial bonus alters the character of the transaction no more than an unusually large rental for the first year alters the character of any other lease." *Burnet* v. *Harmel*, 287 U. S. 103, 106. And this is true whether the bonus is paid to the original lessor, as in the *Harmel* case, or to an assignor of the leasehold estate. *Palmer* v. *Bender*, 287 U. S. 551. "A bonus is not proceeds from the sale of property, but payment in advance for oil and gas to be extracted, and is therefore taxable income." *Herring* v. *Commissioner*, 293 U. S. 322, 324. It must be taken as established in this case that the partnership did not sell but retained its investment in the leasehold in the form of a share in the oil or its proceeds, the income from which was to be received partly in advance by way of the bonus and partly by way of royalty payments measured by one-eighth of production.

The same principles apply to the equipment. This transaction from the point of view of both parties was founded upon the continued production of oil. The entire value of the partnership's retained royalty depended upon such production, and the production of oil unquestionably depended

in part upon the use of the equipment.[*] It was implicit in this contract that the assignee, the holder of the working interest, should continue to use the equipment to produce the oil in which the partnership was to share. Under these circumstances, whatever "title" the assignee may have acquired by virtue of the assignment, it seems clear that the partnership retained an interest in the equipment as long as the wells continued to produce. Such an interest has been recognized and given effect by the courts. In *Orfic Gasoline Production Co.* v. *Herring*, 273 S. W. 944 (Texas Civ. App.), the Texas court, although holding that the plaintiff, an assignee of the lease, had acquired title to the casing, declined to permit its removal "so long as the well is a producing well." We quote from the opinion (p. 945):

> So long as the well is a producer, neither the owner of the well nor the owner of the land would have a right to draw the casing and thereby destroy the well. Since all parties who are interested in the property have an interest in the well, no one would have a right to do any act that would destroy the rights of the co-tenants or co-owners of the property.

See also *Wisconsin-Texas Oil Co.* v. *Clutter*, 258 S. W. 265, 267 (Texas Civ. App.); *Meers* v. *Frick-*

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[*] The relative importance of the six producing wells to the enterprise as a whole is indicated by the fact that the assignee drilled only four additional wells (R. 18).

Reid Supply Corp., 127 S. W. 2d 493, 498 (Texas Civ. App.). And in *Okmulgee Supply Corp.* v. *Anthis*, 189 Okla. 139, the Oklahoma court enjoined the removal of equipment by a purchaser thereof. The court stated (p. 141) that—

> the attempted removal of equipment necessary for the operation of the wells was a violation of the rights of those plaintiffs who as owners of interests in the mineral rights occupied the position of lessors.

As we have stated, the record does not show how the partnership's equipment cost is broken down between the six sets of casings and the rest of the equipment, and it may fairly be assumed that the casings represented the greater part of the cost. Their removal would destroy the wells and it is clear that the partnership retained a sufficient interest by virtue of its royalty to prevent such removal as long as the wells continued to produce. The rest of the equipment was "attached to such producing wells" and, while its removal might not destroy the wells, its continued use was necessary for the continued production contemplated by the contract. We would make no distinction between these two classes of property.

It is immaterial that such equipment may be classed as "trade fixtures" which do not become a part of the real estate but may be removed (so far as physically removable) by the holder of the leasehold when the wells cease to produce,

that "title" to the equipment may have vested in the assignee, or that the partnership may have retained no reversionary interest in respect thereof. Cf. *Burnet* v. *Harmel*, 287 U. S. 103; *Palmer* v. *Bender*, 287 U. S. 551. We quote from the opinion of this Court in the latter case (p. 557):

> Similarly, the lessor's right to a depletion allowance does not depend upon his retention of ownership or any other particular form of legal interest in the mineral content of the land. It is enough if, by virtue of the leasing transaction, he has retained a right to share in the oil produced. If so he has an economic interest in the oil, in place, which is depleted by production.

The decisive consideration is the fact that the leasehold and the fixed equipment of the six wells constituted an operating property which was intended by the parties to produce (along with any new development) the oil in which the partnership was to share.

The taxpayer attacks the decision below on several grounds. It is argued that the cost of physical equipment is recoverable in only two ways, through the depreciation allowance or as the proceeds of an outright sale, and that there is no authority for its recovery by way of depletion. This argument fails to take into account the changed relationship of the partnership to the property and the altered form of its interest.

After the assignment it was no longer the owner of physical equipment used in its trade or business and was of course not entitled to further depreciation; nor had it sold the equipment outright any more than it had sold the leasehold. Its investment after the transfer was no longer an investment in leasehold and equipment as such but was an economic interest in an oil producing enterprise, an interest measured by the production of oil, a depletable interest. The cost of that interest was what the partnership had put into it, its contribution to the reservoir of capital investment measured by the remaining cost of its original investment in the leasehold and equipment.

It is argued that unless the cost of the equipment is recovered out of the bonus payment as a return of capital, the taxpayer can never recover such cost. This is not true. As we have seen, the equipment cost is included as part of the cost of the partnership's resulting depletable interest, and to the extent that such cost is not recovered through percentage depletion it will be recovered through cost depletion, the minimum annual allowance. Section 114 (b) (3), Revenue Act of 1938 (Appendix, *infra*). It will be observed in this connection that under the Commissioner's computation which was sustained by the court below the partnership was allowed depletion against the bonus in the amount of $30,250 (R. 20) for the taxable year of the assignment. This

was sufficient to return almost two-thirds of its investment in leasehold and equipment combined, without regard to the additional cost or percentage depletion allowable in subsequent years against the royalty payments.[14]

It is argued further that the treatment of the bonus payment as a capital item in the assignee's accounting is inconsistent with its treatment as ordinary income subject to depletion in the hands of the partnership. It is true that, in accord with the practice of the industry and of the Commissioner, the Sylva Oil Company on its books set up the bonus as its cost of the leasehold and equipment and allocated this cost between the several items so acquired (R. 18). This treatment of the bonus as a capital item from the point of view of the assignee-payor has never been considered inconsistent with or as casting doubt upon the rule firmly established by the decisions of this Court[15] that a bonus so paid is ordinary income to the assignor-payee. The same principles apply to the treatment of a bonus in the taxation of lessor and lessee under an ordinary

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[14] Under the rule now contended for by the taxpayer, the partnership would recover its equipment cost, $23,090.60, tax free, and in addition would be entitled in the taxable year to a depletion allowance of $23,075.08 (27½ percent of the net bonus after deducting the equipment cost), a total tax free allowance of $46,165.68, substantially equivalent to its entire capital investment, while retaining the royalty interest upon which percentage depletion (computed without regard to cost) will be allowable in subsequent years.

[15] *Palmer* v. *Bender*, *supra*, and like cases.

leasing transaction. *Main & McKinney Bldg. Co.* v. *Commissioner*, 113 F. 2d 81 (C. C. A. 5th), certiorari denied, 311 U. S. 688. See 2 Mertens, Law of Federal Income Taxation, Sec. 12.31:

> It does not follow, except perhaps logically, that bonuses which are income to the lessor in the year of receipt or accrual are deductible by the lessee who pays them in the year paid or incurred. * * * Such payments, as regards the lessee, are considered to be capital expenditures, * * *.

There is a dearth of authorities on the issue involved in this case. The court below followed *Cullen* v. *Commissioner*, 118 F. 2d 651 (C. C. A. 5th), the only prior case on the point.[16] But in deciding the case which is companion to the instant case, *Hogan* v. *Commissioner*, *supra*, the

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[16] *Commissioner* v. *West Production Co.*, 121 F. 2d 9 (C. C. A. 5th), is a companion to the *Cullen* case. The Tax Court in the instant case (R. 22) thought to distinguish the *Cullen* case factually on the ground that the contracts there made no mention of physical equipment. This distinction is not borne out by the record. The granting clause of the assignment, it is true, did not mention the equipment but the *habendum* clause (*Cullen* record 190) did refer to equipment as follows:

"To Have and to Hold said undivided interest in and to the oil and gas mineral leases above described and each of them, * * *, together with a one-half (½) undivided interest in and to all oil wells, gas wells and other wells situated thereon and all wells drilling thereon, and a one-half (½) undivided interest in all physical equipment, fixtures, drilling rigs and other personal property situated thereon * * *."

Circuit Court of Appeals for the Fifth Circuit declined to follow its earlier decision. In *Palmer* v. *Bender*, *supra*, as in the instant case, the subject of the transfer was developed property,[17] and while no question was raised in that case as to whether a part of the cash bonus should be attributed to physical equipment, this Court concluded that the whole bonus payment was depletable. No part of the bonus was treated as proceeds from the sale of equipment.

The cases involving cash payments accompanying the reservation of oil-payment rights[18] are clearly distinguishable. An oil-payment right is a right to share in the oil or its proceeds until a specified quantity of oil or sum in dollars is received. Cf. *Thomas* v. *Perkins*, 301 U. S. 655; *Anderson* v. *Helvering*, 310 U. S. 404. An oil-payment right is considered a reserved interest in the oil in place, and is subject to depletion, but the transfer of an oil lease reserving only an oil-payment right has never been characterized as a sublease and the accompanying cash payment is not advanced royalty but the proceeds of a sale

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[17] The assignment to the Gulf Refining Company (*Palmer* v. *Bender*, *supra*) included "the eleven (11) oil wells on said property, all equipment thereto annexed and attached. * * *." See opinion of District Court (W. D. La.), 49 F. 2d 316, 319.

[18] *Commissioner* v. *Lewis*, 132 F. 2d 709 (C. C. A. 10th); *Columbia Oil & Gas Co.* v. *Commissioner*, 118 F. 2d 459 (C. C. A. 5th); *Commissioner* v. *Roeser & Pendleton, Inc.*, 118 F. 2d 462 (C. C. A. 5th), certiorari denied, 314 U. S. 635, rehearing denied, 314 U. S. 711; *Thomas* v. *Peckham Oil Co.*, 115 F. 2d 685 (C. C. A. 5th).

pro tanto of the taxpayer's interest, a sale of the assignor's interest less the oil-payment interest retained. *Commissioner* v. *Fleming,* 82 F. 2d 324 (C. C. A. 5th); *Thomas* v. *Perkins, supra.* In such cases, where no royalty interest is retained and where the transaction is regarded as a sale of all but the retained interest, the taxpayer is permitted to recover the undepreciated cost of his equipment out of the cash payment. (See cases cited in fn. 18.) The soundness of these latter cases may be questioned; there appears to be no basis for the assumption that the equipment even in the oil-payment cases should be treated as wholly sold where the assignor has retained a depletable interest in the producing enterprise. The sounder rule would require the allocation of the equipment cost as well as the leasehold cost between the part sold and the part retained in proportion to the respective values of the two parts.[19]

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[19] The following illustration is based upon the figures in *Columbia Oil & Gas Co.* v. *Commissioner, supra,* footnote 18, which appears in the opinion of the Board of Tax Appeals in that case, 41 B. T. A. 38, 47:

Assignor's costs:		
Leasehold	$133,307.78	
Equipment	246,590.00	
Total cost	$379,897.78	
Cash payment by assignee		$550,000
Oil-payment right—$350,000 valued at		175,000
Total value of property at time of sale		$725,000

The total cost, including the equipment, should be apportioned between the part sold (valued at $550,000) and the

In acquiescing in the rule of the decided cases the Chief Counsel of the Bureau of Internal Revenue in G. C. M. 23623, 1943 Cum. Bull. 313, emphasized the distinction between the two types of cases:

> Care should, of course, be exercised in confining the application of the stated rule to those cases in which the assignment effects a sale, as differentiated from a transaction

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part retained (valued at $175,000) in proportion to their respective values, thus:

$\frac{550,000}{725,000} \times \$379,897.78 = \$288,198.32$ (cost of part sold)

$\frac{175,000}{725,000} \times \$379,897.78 = \$91,699.46$ (cost of part retained, recoverable through depletion)

Capital gain on part sold:

Sales price	$550,000.00
Less cost	288,198.32
Profit	$261,801.68

The leasehold and equipment should be treated as a unit as to which the assignor has retained, by virtue of the oil-payment right, a depletable economic interest dependent upon production.

The court in the *Columbia* case and the other cases cited in footnote 18 held however that in such cases the equipment is to be treated as sold outright and its cost deducted in full from the cash payment as a return of capital. No part of the equipment cost was charged to the retained oil-payment right.

In no case has a loss been allowed in connection with such a transaction. If there were no cash payment or if the cash payment were insufficient to cover the equipment cost the unrecovered cost of the equipment would become a part of the cost of the oil-payment right and would accordingly be recoverable only through depletion. (See G. C. M. 23623, 1943 Cum. Bull. 313.) This demonstrates the illogical and arbitrary nature of the rule of the *Columbia* case.

> in which the assignor or sublessor retains a royalty interest throughout the productive life of the property, * * *.

The rule for which we contend comports with the realities of the transaction, which contemplates the continued use of the equipment for the production of the oil in which the partnership is to share. The contrary rule would, as the court below points out in its opinion, permit of manipulation by taxpayers in the reduction of their tax liabilities. The rule for which the taxpayer contends presupposes a separate sale of the equipment for cash, and the logic of this rule would seem to compel the allowance of a loss if the cash were insufficient to return to the taxpayer his full undepreciated cost.[20] Transactions of this sort are wholly flexible in regard to the amount of the cash payment or bonus, and will vary between the extremes of no cash with a large royalty and practically all cash with a very small royalty. The determining factor from the point of view of the assignor is the extent to which he is prepared to speculate or continue his speculation in the production of the oil, and there is no neces-

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[20] This, upon the theory that if the partnership had received a cash bonus of less than $23,090.60, it would have sustained a deductible loss. See the dissenting opinion of Phillips, C. J., in the court below (R. 46):

"It is my opinion that there was a sale of the equipment. * * * If this be true, then W. G. Choate was entitled to deduct * * * one hundred per cent of the loss if it was sold for an amount less than the depreciated cost."

sary relationship between the amount of the bonus and the assignor's investment in either leasehold or equipment, or both combined. Yet if lessors and assignors of oil leases are permitted, as the lessor or sublessor of improved real estate is not, to bargain separately for the sale of the fixed equipment, the bargain will inevitably be affected by the fact that the proceeds allocated to the equipment will be received tax free as a return of capital with any profit taxed at capital gain rates.

The rule contended for in the instant case has been followed in practice by the Commissioner, though it is embodied in no regulation or published ruling except inferentially in the Chief Counsel's memorandum quoted above.[21] The rule is implicit, however, in the principles announced by this Court in *Palmer* v. *Bender, supra,* and subsequent cases (p. 558):

> Thus, throughout their changing relationships with respect to the properties, the oil in the ground was a reservoir of capital investment of the several parties, all of whom, the original lessors, the two partnerships and their transferees, were entitled to share in the oil produced.

The partnership has merely changed its relationship to the oil in place, the reservoir of capital

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[21] G. C. M. 23623, 1943 Cum. Bull. 313. See, however, the general discussion of the status of oil and gas leasing transactions in G. C. M. 22730, 1941-1 Cum. Bull. 214.

investment. An investment formerly represented by the leasehold rights and depreciable physical property is now represented only by a depletable royalty interest, an interest measured by a share of the oil produced and therefore dependent upon the continued operation of this producing property.

CONCLUSION

The judgment below should be affirmed.

Respectfully submitted,

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DECEMBER 1944.

APPENDIX

Revenue Act of 1938, c. 289, 52 Stat. 447:

SEC. 23. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

* * * * *

(l) *Depreciation.*—A reasonable allowance for the exhaustion, wear and tear of property used in the trade or business, including a reasonable allowance for obsolescence. * * *

(m) *Depletion.*—In the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case; such reasonable allowance in all cases to be made under rules and regulations to be prescribed by the Commissioner, with the approval of the Secretary. * * * In the case of leases the deductions shall be equitably apportioned between the lessor and lessee. * * * (For percentage depletion allowable under this subsection, see section 114 (b)(3), (3) and (4).)

(n) *Basis for depreciation and depletion.*—The basis upon which depletion, exhaustion, wear and tear, and obsolescence are to be allowed in respect of any property shall be as provided in section 114.

* * * * *

SEC. 111. DETERMINATION OF AMOUNT OF, AND RECOGNITION OF, GAIN OR LOSS.

(a) *Computation of gain or loss.*—The gain from the sale or other disposition of

property shall be the excess of the amount realized therefrom over the adjusted basis provided in section 113 (b) for determining gain, and the loss shall be the excess of the adjusted basis provided in such section for determining loss over the amount realized.

* * * * *

SEC. 113. ADJUSTED BASIS FOR DETERMINING GAIN OR LOSS.

(a) *Basis (Unadjusted) of Property.*—The basis of property shall be the cost of such property; * * *

* * * * *

(b) *Adjusted basis.*—The adjusted basis for determining the gain or loss from the sale or other disposition of property, whenever acquired, shall be the basis determined under subsection (a), adjusted as hereinafter provided.

(1) *General rule.*—Proper adjustment in respect of the property shall in all cases be made—

* * * * *

(B) in respect of any period since February 28, 1913, for exhaustion, wear and tear, obsolescence, amortization, and depletion, to the extent allowed (but not less that the amount allowable) under this Act or prior income tax laws. * * *

* * * * *

SEC. 114. BASIS FOR DEPRECIATION AND DEPLETION.

(a) *Basis for depreciation.*—The basis upon which exhaustion, wear and tear, and obsolescence are to be allowed in respect of any property shall be the adjusted basis provided in section 113 (b) for the purpose

of determining the gain upon the sale or other disposition of such property.

(b) *Basis for depletion.*—

* * * * *

(3) *Percentage depletion for oil and gas wells.*—In the case of oil and gas wells the allowance for depletion under section 23 (m) shall be 27½ per centum of the gross income from the property during the taxable year, excluding from such gross income an amount equal to any rents or royalties paid or incurred by the taxpayer in respect of the property. Such allowance shall not exceed 50 per centum of the net income of the taxpayer (computed without allowance for depletion) from the property, except that in no case shall the depletion allowance under section 23 (m) be less than it would be if computed without reference to this paragraph.

* * * * *

Treasury Regulations 101, promulgated under the Revenue Act of 1938:

ART. 23 (m)-10. *Depletion—Adjustments of accounts based on bonus or advanced royalty.*— * * *

* * * * *

(*d*) In lieu of the treatment provided for in the above paragraphs the lessor of oil and gas wells may take as a depletion deduction in respect of any bonus or advanced royalty from the property for the taxable year 27½ percent of the amount thereof * * * but the deduction shall not in any case exceed 50 percent of the net income of the taxpayer (computed without allowance for depletion) from the property.

* * * * *

ART. 23 (m)-18. *Depreciation of improvements in the case of oil and gas wells.*—Both owners and lessees operating oil or gas properties will, in addition to and apart from the deduction allowable for depletion as hereinbefore provided, be permitted to deduct a reasonable allowance for depreciation of physical property, such as machinery, tools, equipment, pipes, etc., so far as not in conflict with the option exercised by the taxpayer under article 23 (m)-16. The amount deductible on this account shall be such an amount based upon its cost or other basis equitably distributed over its useful life as will bring such property to its true salvage value when no longer useful for the purpose for which such property was acquired. Accordingly, where it can be shown to the satisfaction of the Commissioner that the reasonable expectation of the economic life of the oil or gas deposit with which the property is connected is shorter than the normal useful life of the physical property, the amount annually deductible for depreciation on such property may be based upon the length of life of the deposit. * * *

U. S. GOVERNMENT PRINTING OFFICE: 1944

SUPREME COURT OF THE UNITED STATES.

No. 93.—October Term, 1944.

W. G. Choate, Petitioner, vs. Commissioner of Internal Revenue. } On Writ of Certiorari to the United States Circuit Court of Appeals for the Tenth Circuit.

[January 29, 1945.]

Mr. Justice Douglas delivered the opinion of the Court.

In 1936 Choate and Hogan, a partnership of which the petitioner was a member, acquired an oil and gas lease. They drilled six producing wells on the leased land and operated the property until August, 1938. At that time they sold to Sylva Oil Co. for a cash consideration of $110,000 all their right, title and interest in the lease "together with all wells and the equipment thereof, including pumps, casing, piping, tanks, lease house, and all other personal property on or used in connection" with the premises. But they expressly reserved to themselves "1/8 of the 8/8ths of all oil and gas and casinghead gas which may be produced and saved" from the land. Thereafter Sylva Oil Co. drilled additional wells and operated the lease. Choate and Hogan in their partnership return for 1938 reported the transaction as a sale. Respondent in his deficiency notice ruled that the transaction constituted a sublease. The Tax Court took the same view, holding that the partners must look to depletion for the return of their capital. It held that the principle of recovery by depletion was applicable where a royalty interest was retained and that a cash bonus was to be regarded as in the nature of an advance royalty. It held, however, that there had been an absolute sale of the equipment, that its cost was not recoverable by depletion, and that the partners were entitled to an allowance for the unrecovered cost of the equipment transferred. The Commissioner challenged the latter ruling—in the Circuit Court of Appeals for the Tenth Circuit as respects Choate, in the Circuit Court of Appeals for the Fifth Circuit as respects Hogan. The Commissioner won in the Tenth Circuit (141 F. 2d 641) and lost in the Fifth. *Hogan* v. *Commissioner*, 141 F. 2d 92. It was to resolve that conflict that we

granted the petition in the present case limited to that single question.

The Commissioner makes an elaborate argument based on the assumption that there was no sale of the equipment. The assumption is that after the partnership transferred its interest in the lease its investment was no longer in the leasehold and equipment as such but was an economic interest in an oil producing enterprise—an interest which is depletable since it is measured by the production of oil. But there are two difficulties with that argument. In the first place, we find nothing in the Revenue Act of 1938, 52 Stat. 447, or in the Treasury Regulations which provides for depletion of equipment used in the operation of oil and gas wells. A deduction is allowed for depreciation by § 23(l) which permits a "reasonable allowance for the exhaustion, wear and tear of property used in the trade or business". And see Treasury Regulations 101, Art. 23(m)-18. Sec. 23(m) provides that in the case of "mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case" may be taken as a deduction. And see Treasury Regulations 101, Art. 23(m)-10. Depletion is applicable to wasting assets—to the exhaustion of natural resources, not of property used in a business. See 4 Mertens, Law of Federal Income Taxation (1942) § 24.02. That distinction between depletion and depreciation runs through the basis provisions of the Act. See § 111(a), § 113(a) and (b), § 114(a) and (b). And the history of the depletion provisions indeed makes clear that only intangible drilling and development costs, not costs represented by physical property, are returnable by way of depletion. See *United States* v. *Dakota-Montana Oil Co.*, 288 U. S. 459; 4 Mertens, *op. cit.*, § 24.48; Treasury Regulations 101, Art 23(m)-16(a). In the second place, the Tax Court found that the parties intended a cash sale of the equipment. That question is argued here as if it were open for redetermination by us. It is not. It is the kind of issue reserved for the Tax Court under *Dobson* v. *Commissioner*, 320 U. S. 489 and *Wilmington Co.* v. *Helvering*, 316 U. S. 164, 167-168. Once a sale of the equipment is conceded, it is not denied that petitioner is entitled to an allowance for the unrecovered cost of the equipment transferred. Sec. 111(a), § 113(a) and (b). No question is presented concerning the allocation of a portion of the purchase price to the equipment.

Reversed.